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To:

Cc:

Subject: Brief summary of facts for question of deductibility of backup withholding taxes

Hi

We have a number of banks that have neglected to backup withhold under § 3406 of the Internal Revenue Code. Under § 3406, when a taxpayer makes a “reportable payment” (e.g., certain dividend or interest payments), but fails to meet the requirements of § 3406(a) (e.g., does not provide its TIN to the bank receiving the payment), then the bank receiving the payment is required to withhold a statutory amount (backup withhold) from the taxpayer’s payment.

Currently, the Service has several cases involving financial institutions that are “coming clean” by voluntarily disclosing to the Service that they failed to backup withhold payments of interest, dividends, and proceeds from the sale of stocks and securities made to individuals, corporations, partnerships, trusts, and other entities. The financial institutions were required to backup withhold because these payments fell into one of the “red flag” categories listed in § 3406(a).

As part of this voluntary disclosure, the financial institutions are entering into closing agreements with the Service under which they will agree to pay the correct amount of backup withholding liability pursuant to § 3406, plus interest. The banks are precluded by § 275 from deducting the backup withholding payments. However, the banks argue that they should be permitted to deduct the interest.

After coordinating with _____ we _____ conclude that the interest paid by these financial institutions on their backup withholding liabilities is deductible under § 163. Furthermore, the interest is deductible when accrued under §§ 446 and 461. See 2002 IRS CCA LEXIS 71 (Issue #2) (attached).

If you have any further questions on this issue, please do not hesitate to contact me at _____.